Trinity Student Managed Fund
Research Team

Analysis On The Mexican Economy

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TRINITY SMF
STUDENT MANAGED FUND

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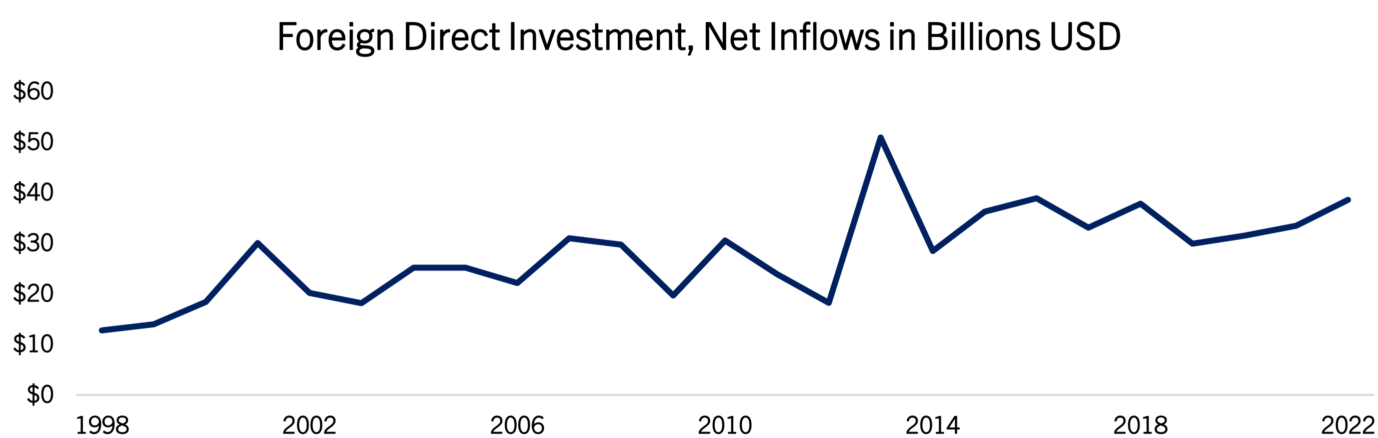
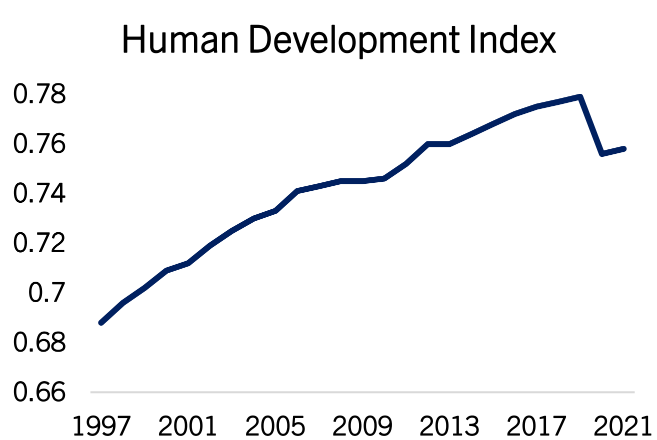
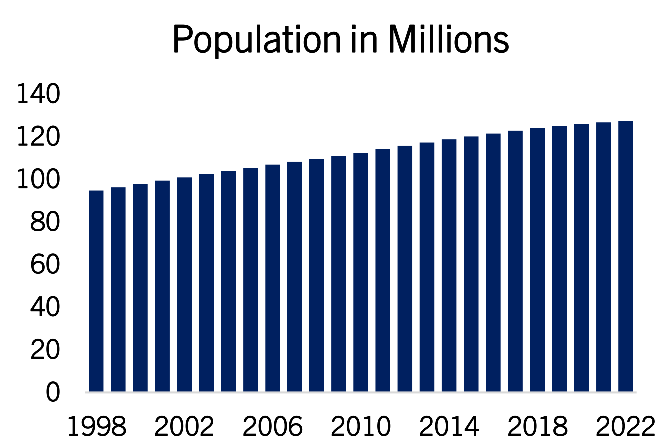
At a Glance…

Evolution of Key Macro Indicators						
Indicator	2017	2018	2019	2020	2021	2022
GDP	1,158.9B	1,222.4B	1,269.0B	1,090.5B	1,272.8B	1,414.2B
Growth Rate	(6.9%)	5.5%	3.8%	(14.1%)	16.7%	11.1%
Govt Debt as a % of GDP	35.2%	35.3%	36.1%	41.4%	40.7%	N/A
Inflation	6.0%	4.9%	3.6%	3.4%	5.7%	7.9%
Real Interest Rate	0.6%	2.9%	4.1%	2.1%	(0.3%)	1.1%
Unemployment Rate	3.4%	3.3%	3.5%	4.5%	4.1%	3.3%







Recent Economic Developments

MEXICO'S ECONOMIC STRENGTH & OIL ADVANTAGE IN A SHIFTING GLOBAL MARKET

Mexico derives strength from its responsible economic, financial, and commercial policies, all aimed at strengthening the domestic market. Economic activity has been resilient to low oil prices, weak world trade growth, and monetary policy tightening in the United States. Amidst these factors, domestic demand remains the main driver of economic activity. (1) Recent structural reforms have cut consumer prices, notably on electricity and telecom services, allowing consumers to allocate their spending elsewhere. In addition to robust consumer demand, Mexico also benefits from the production and export of its crude oil. As one of the world's largest exporters, Mexico can continue producing and exporting oil at its discretion which has allowed it to take advantage of higher oil prices. (2) Average crude oil production is trending around 1.88m barrels/day in 2023 and is expected to rise to 1.91m next year. (3) Crude exports are projected to average 800,000 barrels/day in 2023 and decline slightly to 786,000 in 2024. (4) Mexico's activities in the oil market position the country to take advantage of favorable market conditions and benefit from OPEC's recent decision to cut production.

RISING GDP LEVELS

Following an 8.0% fall in 2020 after the pandemic, Mexico's economy has rebounded with stronger-than-expected GDP and employment levels. The Mexican economy grew by 3.1% in 2022 and is set to continue on this course which is supported by its stable macroeconomy and manufacturing industries. Mexico's GDP expanded by 3.7% in Q2 of 2023, which beat market estimates of 3.4%. Much of this growth can be attributed to the free trade agreements Mexico has with other countries. Not only does ~90% of total trade fall under these agreements, but the manufacturing and services sectors have also shown strong signs. (5)

MEXICO'S PUBLIC DEBT

Mexico's total debt has increased more than $150bn to roughly $880bn since the onset of the COVID-19 pandemic. (20) This increase can be attributed to the various measures implemented to support the economy and health system. Some of the uses included during the crisis was a slight increased government spending, tax deferrals, and loan guarantees. However, Mexico contributed only about 3% of its GDP to spending on COVID-19 plans to avoid further public debt. Instead, Mexico terminated non-essential and non-strategic trusts (for arts, cinema, sciences) and redistributed these funds towards COVID-19 related plans. (21) The Mexican government's main goal is to decrease public debt without borrowing from outer organizations such as the IMF to ensure there is no further future increase in public debt. The government has also implemented other measures to address rising public debt, such as implementing a fiscal consolidation plan and increasing tax revenues. However, these efforts have demonstrated mixed success. Overall, Mexico's public debt has risen, driven by a combination of external factors and domestic policies.

Economic Policies

FREE TRADE AGREEMENTS

Mexico has signed various free trade agreements to help increase trade, attract foreign investment, and boost economic growth. Some of the following are included below.

- North American Free Trade Agreement (NAFTA)
  - Includes: Mexico, the United States, and Canada

    - NAFTA created a large free-trade zone which reduces or eliminates tariffs on imports and exports between the three participating countries (Mexico, United States and Canada). NAFTA has increased trade between these countries and is expected to do so into the future

- Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)
    - Includes: Canada, Peru, Chile, New Zealand, Australia, Brunei, Singapore, Malaysia, Vietnam, and Japan
    - Upon investment, the CPTPP facilitates confidence in Canadian investment in Mexico. It protects from unfair and discriminatory treatment while providing greater predictability and transparency in trade.

GEOGRPAHY & INDUSTRY

The United States is Mexico's most important trading partner with total investments into Mexico valued at roughly $130bn in 2022. (6) The trend of American companies reshoring supply chains in Mexico has grown rapidly in recent years to ease supply chain constraints. Total U.S foreign direct investments into Mexico equaled $29 billion in the first half of 2023, an increase of 41% from the same period in 2022. (7) Increasing investments is indicative of a growing US presence as companies settle across the border. Exports from Mexico to the U.S. increased 49% from 2016-2022 with Mexico gaining import market share. (22) Mexico's advantageous position near the U.S., its robust export-oriented industrials sector, and its participation in the US-Canada-Mexico trade agreement contribute significantly to real economic benefits. Mexico's openness to trade, including updated provisions in the USMCA (United States-Mexico-Canada Agreement) regarding rules of origin, protection of IP, and harmonizing of regulations, allow business to be conducted in a seamless manner. Shared time zones have a similar effect, making it very attractive for large companies selling products in the US to set up manufacturing locations in Mexico. Ford, Tesla, Audi, and BMW have all emerged as major players in Mexico's automotive sector.

There are significant advantages to offshore in Mexico, particularly for the United States. These include the previously mentioned USMCA agreement. Mexico also has low labor costs and fast and secure supply chains. These conditions are favorable particularly for offshoring a US company as it can increase supply chain efficiency within close proximity to the US borders. Mexico also features world-class industries that can be lucrative for companies in the automotive and aerospace industries in particular. With the lack of stability in relations between China and the United States, Mexico's geographic location and its cheap, efficient industrial sector can supersede current US supply chains.

IMMEX

The IMMEX program helps attract foreign investors through various incentives. Under this, a foreign company can set up a legal entity in Mexico (either through ownership or outsourcing), import raw materials duty-free, produce goods from those materials within the country, and then export those goods. It must be noted that the export of those goods must be done within a certain timeframe (ranging from five to 24 months) depending on the industry. (8) IMMEX offers several tax and financial benefits to participants. These benefits include duty-free (or VAT exemption) on specific imports and lower corporate tax rates. American businesses can take advantage of Mexico's geographic positioning, allowing lower operational expense costs enabled by the proximity of business operations and convenient accessibility. This is where nearshoring will also come into play as more companies seek ways to set up manufacturing or outsourced operations closer to their destination markets. Mexico has implemented fiscal policies to control government spending and reduce public debt (a balanced budget, reducing subsidies, and increasing tax revenues). Mexico has invested in infrastructure projects such as new railways, highways, airports, industrial parks and ports to improve transportation and attract more foreign investment. These investments support IMMEX and the nearshoring of supply chains.

INTEREST RATES

The Bank of Mexico has set interest rates at 11.25% to stifle inflation. This represents nearly a tripling of rates since 2021, when rates were at 4.00%. Since these rate hikes, inflation has moderated to a current level of 4.64%, remaining above the 3.00% target.

The decision to increase rates opposes what some other countries in Latin America (e.g., Brazil and Chile) are doing. However, the Bank of Mexico is unlikely to cut this rate soon to ensure the current level is sustainable for their inflation target. (15) The graph below demonstrates that the inflation rate has decreased compared to the same period the previous year with the inflation rate falling to 4.64% in August of 2023, the lowest since October 2021. Though deflation has persisted, the rate of inflation remains above Mexico's target rate. Inflation impacts economies negatively, by reducing consumer purchasing power and increasing business costs. Mexico's government is set to maintain high interest rates for an extended period to stimulate further deflation.

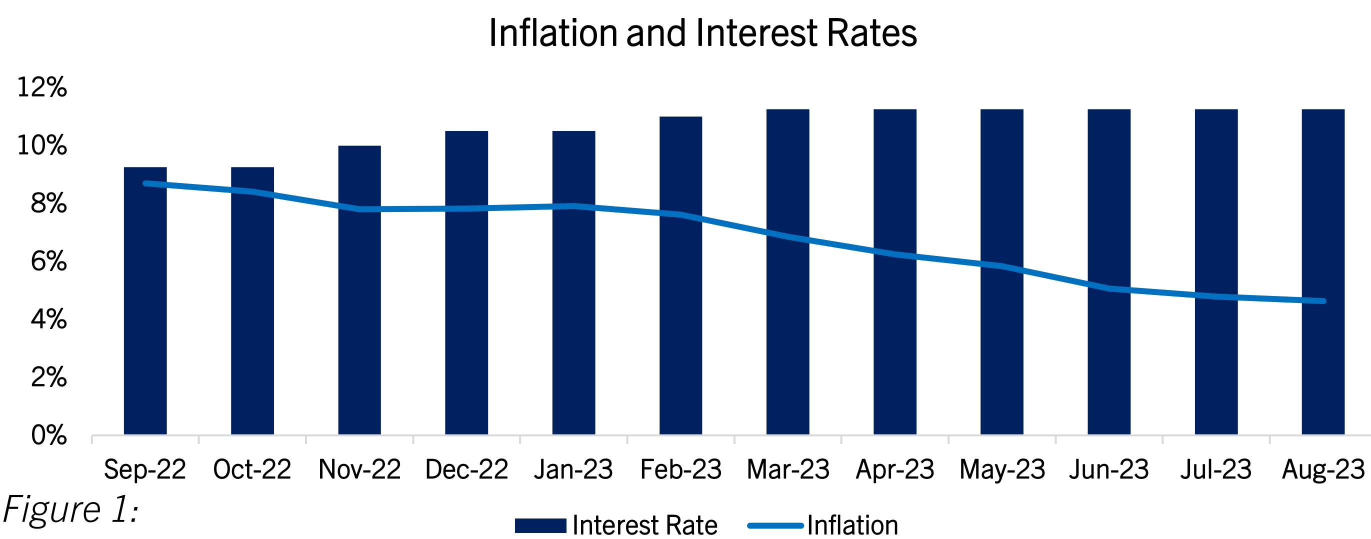


Figure 1:

COMBATING RISING LIVING COSTS

In a significant move aimed at alleviating the burden of increasing living expenses, Mexican president Andrés Manuel López Obrador has eliminated tariffs on dozens of basic food and household items in a bid to combat rising living costs, under a decree published on May 16th, 2022. (9) The decree exempts 66 items from import and export tariffs, including rice, pork, beef, corn flour, beans, and soap.

Structural and Institutional Developments

In recent years, Mexico has been working on their anti-corruption measures. (10) They have implemented several measures to combat corruption, including creating a specialized anti-corruption prosecutor's office and establishing a national anti-corruption system. Mexico has made significant efforts to digitize its economy, including developing e-government services. Digitization can be a powerful tool in the broader effort to reduce corruption by promoting transparency, efficiency and accountability in government and business processes. It is illegal in Mexico for any official to accept any form of gift from a third party, as this is considered a bribe.

MEXICO CORRUPTION INDEX

The Corruption Perceptions Index ranks countries and territories based on how corrupt their public sector is perceived to be. A country or territory's score indicates the perceived level of public sector corruption on a scale of 0 (highly corrupt) to 100 (no corruption).

The corruption perception index score remained stable at 31 points in 2020, 2021, and 2022. (11) Mexico ranked 23rd among 31 Latin American countries on their perceived corruption index score. The worst possible score in the perception of corruption is 0, whereas a score of 100 indicates that no corruption is perceived in the respective country. (13)(14)

This index is a composite indicator that includes data on the perception of corruption in areas such as bribery of public officials, kickbacks in public procurement, embezzlement of state funds, and the effectiveness of the government's anti-corruption efforts.

Actual	Previous	Highest	Lowest	Dates	Frequency
34.4	31	37	26.6	'95 - '22	Annually

Political Situation

The political situation in Mexico is influenced by ongoing challenges related to organized crime, drug trafficking, and violence. The country has experienced high levels of violence and insecurity in recent years. As such, addressing these issues remains a significant challenge for the government. President Andrés Manuel López Obrador is from oil producing state Tabasco in Southeast Mexico and plans on growing Mexico's southern region through government investment. He is planning two flagship projects: the Olemca Refinery and Maya train that cuts through the Yucatan Peninsula. Mexico has awarded billions of dollars in financing for these projects. (16)

Mexico benefits from friendly relations with neighboring countries, which makes geopolitical risk low. They have many diverse supply chains and trade agreements that help make them more resilient to geopolitical risks. For example, Mexico is indirectly benefitting from the Russian and Ukraine war regarding trade opportunities and rising commodity prices. Mexico can also continue to benefit from the dwindling relationship between China and the United States due to its location. However, it must be noted that close trade and association with the United States also brings correlation regarding bull and bear markets.

Key Trends and Outlooks

MEXICO'S STRONG ECONOMIC OUTLOOK & STRATEGIC APPEAL FOR MULTINATIONAL COMPANIES

Mexico is expected to grow 3% to 4% this year according to the Finance Ministry. (16) The southern region is leading growth at double the pace of the national level which is fueled by the aforementioned state projects. In early September, the Ministry said they expected overall growth in Mexico to be 2.5%-3.5% in 2024.

The government has fiscal incentives for companies that choose to invest in the southern region. These new tax incentives will help lure companies into the south. (19) The incentives will be available to companies that operate in manufacturing industries such as automotive, semiconductor chips, medical devices, and industrial machinery, along with firms in sectors such as information technology, petrochemicals, pharmaceuticals, and energy. (18) Companies that invest in the inter-oceanic corridor connecting the Pacific region of Salina Cruz in Oaxaca with the Gulf Coast of Coatzacoalcos in Veracruz will not need to pay income tax during the first three years of operations. In the following three years, these companies will pay only half of their normal tax expense, a discount of up to 90% if the companies meet certain employment goals. The measures also include accelerated depreciation of investment during first six years of operation which benefits companies by lowering the taxable amount on their annual income. The businesses in this corridor will also be exempt from value added tax (VAT) and firms can claim back VAT from purchases made outside the zone for four years. These measures are all part of President Andrés Manuel López Obrador's drive to create jobs and lift the economy of Mexico's poorest south. The government plans to build 10 industrial parks along the corridor, the backbone of which is to be an upgraded rail link between the coasts. This will allow transport, fuel, cement, iron, grain, vehicles among others to be transported more efficiently. Currently 81.8% (185km/226km) of this new rail line is complete. (17)

NEARSHORING

Nearshoring offers some offset to a possible US-influenced slowdown in growth as well as being a long-term structural support. (12) A nearshoring trend would drive global businesses to move supply chains closer to home and could substantially boost U.S. investment in Mexico. Mexico could see a $155 billion surge in exports to the U.S. – or more than 10% of Mexico's GDP – over a five-year period. The electronics, metals, auto, and machinery sectors could be the greatest beneficiaries. Estimates from the Inter-American Development Bank (IDB) indicate that nearshoring could potentially generate a $35 billion increase in US-bound Mexican exports. The overall strength of the Mexican government is improving. Still, there is no ignoring the rising level of crime particularly linked to drug cartels and trafficking, high corruption levels surfing on poverty and inequality. The potential benefits of nearshoring can have both indirect and direct implications for Mexico's political situation. Economic growth can bolster the government's resources and capacity to address challenges like crime and corruption, while also improving living conditions for citizens, which can contribute to social and political stability.

Summary

Mexico is the second largest economy in Latin America and has free trade agreements with over 50 countries, including the United States, Canada, and ten Latin American countries. Mexico's economy was relatively robust in 2022, while its equity market comfortably outperformed the MSCI Emerging Markets Index. Mexico's economy has shown resilience and growth, supported by trade liberalization, fiscal policies, investment in infrastructure, and social programs. The country has made efforts to combat corruption and promote digital transformation. While organized crime and violence are challenges, the nearshoring trend and a diversified economy present opportunities for foreign investment to improve the economic situation.

Recommendation

Based on the information provided, investing in Mexico could present opportunities for multinational companies looking to reduce manufacturing costs, take advantage of trade agreements, and tap into a large and growing consumer market. Overall, investing in companies tied to such supply chains could offer attractive opportunities for investors.

About the Contributing Team

MIGUEL M. SHETREET - Head of Research and Investment Officer

Miguel is a third-year Global Business student and is the Head of Research and an Investment Officer in the Trinity Student Managed Fund for the 2023/24 session. Last year, he was the Industrials Sector Manager and began in the fund as a Junior Analyst in the Real Estate sector. After a successful summer, Miguel will be returning to DigitalBridge as a Private Equity Summer Analyst. Additionally, he has also held internships at Charlesbank Capital Partners, Glasswing Ventures, and built an app to combat food waste. His hobbies include surfing, playing poker, and listening to podcasts.

MEG MURPHY - Senior Research Analyst

Meg is a second-year Global Business student and is a Senior Research Analyst in the SMF for the 2023/24 session. She began as a Junior Analyst in the Energy sector last year. Outside of the fund, Meg has participated in various KPMG events related to tax, asset management, and aviation between Ireland and New York. She also participated in the KPMG Leasing School and has been working with Eirlink International Limited as a Research Analyst Intern. Her hobbies include workout classes, cooking, and listening to music.

EMILY LYONS - Senior Research Analyst

Emily is a second-year BESS student specializing in Business, Economics and Politics. For the 23/24 academic session, she is participating in the SMF through the position of senior research analyst. She began in the fund as a junior analyst in the Pharma sector. She particularly enjoys researching the fields of sustainability whilst intertwining economics and management. Her hobbies include listening to podcasts, listening to and playing music and sports.

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